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April 25, 2008

Arizona Corporation Commission
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Commissioner Kristin K. Mayes
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona 85007

Re: APS Rate Case; Docket No. E-01345A-08-0172

Dear Commissioner Mayes:

This letter responds to your April 8, 2008 letter, in which Arizona Public Service Company ("APS" or "Company") was asked to discuss its selection of a test year ending September 2007, and explain how the choice of that test year and the proposal to include post-test year plant in rate base is consistent with the Commission's traditional use of an historical test year rate-making methodology. The April 8th letter further requested APS to provide the Company's interpretation of *Arizona Corporation Commission v. Arizona Public Service Company*, 113 Ariz. 368, 555 P.2d 326 (1976).

**1. Choice of Test Year**

The implication in your letter is that APS is required to wait at least 12 months following one rate decision before submitting a new application to increase rates. However, there is no provision in the Arizona Revised Statutes, the Arizona Constitution, or the Arizona Administrative Code ("A.A.C.") that imposes such a restriction. Neither is APS aware of such a restriction in any other jurisdiction. Indeed, limiting a utility's right to seek just and reasonable rates would clearly violate our Constitution, which imposes upon the Commission the unqualified obligation to set just and reasonable rates while at the same time granting the utility the unqualified right to have just and reasonable rates, *i.e.*, rates that permit it the opportunity to earn a reasonable return on the fair value of its property. *See Simms v. Round Valley Light & Power Company*, 80 Ariz. 145, 294 P.2d 378 (1956).

Commission rule A.A.C. R14-2-103 ("Rule 103" – also sometimes referred to as the "Rate Case Management Rule") governs applications seeking to increase rates. Nowhere in that rule does it indicate that existing rates must have been in effect for any specified period before a new rate application can be made. To the contrary, Rule 103 (B) (11) (g) specifically contemplates the situation in which a utility "pancakes" rate filings, that is, when it files a second rate application prior to the resolution of a pending rate request, and indicates that the "timeclock" provisions of the Rule will not

apply to the second filing. The Rule does not, however, prohibit "pancaked" rate filings, which obviously would not have 12 months of experience under the rates proposed in the first pending filing or any Commission order resulting from that filing.[1] If a utility were restricted from filing the second rate case in the circumstances posed above, the Commission's Rule would not have to address the subject of "pancaked" rate filings. Indeed, this provision of the Rate Case Management Rule would be rendered utterly meaningless and wholly unnecessary if a utility was required to wait a full 12 months after the effective date of one rate change before it was permitted to file a second application. *See Thomas & King, Inc. v. City of Phoenix*, 208 Ariz. 203, 207, 92 P.3d 429, 433 (App. 2004) ("Administrative rules and regulations and statutes are read in conjunction with each other and harmonized whenever possible. We must avoid any interpretations making any language superfluous or redundant.") (internal citations omitted).

Your letter also appears to suggest that APS is requesting a future test year in the March 24th filing. Although, as will be discussed later in the Company's response, such a request would have been proper and consistent with the Commission's requirement that projected data be provided in the filing in addition to historic data,[2] making pro forma adjustments to annualize the impact of APS's last rate order does not constitute a "future test year." Rather, the inclusion of such data is consistent with the Commission's traditional approach to rate-making. As the Commission has long recognized:

> While this commission utilizes, and utilizes herein, an historical test period, we also recognize that carefully made adjustments to and normalizations in an historical test-year framework improve the commission's ability fairly to evaluate. This commission increasingly recognizes that the function of these adjustments tend to the creation of a model test year which, though based upon an historical test period and data established therein, may vary substantially in some aspects from the unadjusted historical test period. This commission, conscious that its test period approach tends increasingly to approach a model test period based analysis, finds that the potential for improving analysis technique far outweighs the limitations of a strict historical test period. [Decision No. 51009 (May 29, 1980) at 6-7.]

In a subsequent proceeding, it was specifically acknowledged that the Commission's employment of an historic test year combined with the allowance of pro forma additions for known and measurable changes "is a very good combination of both historic and future test years." *See* Decision No. 65350 (November 1, 2002) at 9.

Attached is a chart showing every APS application for a rate increase since the adoption of Rule 103. As you can see, in **no** case had current rates been in effect during all of the test year. And yet, on each occasion the filing was accepted by the Commission. In fact, the Company's previous rate application involved a test period that included only six months under the then-existing rates.

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[1] *See also* Decision No. 57875 (May 18, 1992) at 33-34, wherein "pancaked" rate requests are discussed in conjunction with the Rate Case Management Rule.

[2] Schedule F to the Commission's Standard Filing Requirements under Rule 103 require projected data for at least two years subsequent to the test year.

Decision No. 69663 (June 29, 2007) further supports the Company's position. In the portion of the opinion that led to the rejection of APS's requested attrition adjustment, there is a clearly articulated discussion that APS can file a rate case whenever it believes it is not earning a fair return:

> Once rates are set and customers start paying the new rates, those costs of service established in the rate case can change. They can increase and they can decrease. **It is the Company's responsibility to monitor its financial condition and seek approval for new rates when the relationship established in the prior rate case no longer allows it to provide the appropriate level of service or earn a reasonable rate of return. . . .**
>
> **It is at that point [when rates are not just and reasonable] that the utility must make a determination to file a rate application, where that "relationship" between costs and service can be re-established to provide rates and charges that are just and reasonable. . . .**
>
> **We believe that APS should also continue its efforts to increase its creditworthiness by . . . seeking rate relief from the Commission when necessary . . . .**

Decision No. 69663 at 64, 66, and 68 (emphasis supplied).

Although APS does not agree that a constant stream of "back-to-back" rate cases is an adequate remedy to the problem of attrition, this Commission order appears to have contemplated this circumstance. And nowhere in the Commission's lengthy discussion on when a second rate application should be filed is any reference to a one-year period in which a Company would be prohibited from filing a second rate application.

The above legal analyses aside, APS is discussing sufficiency issues with Commission Staff with the goal of reaching a pragmatic resolution of such issues. The Company continues to work with Commission Staff in an effort to resolve any concerns about the appropriate test period for this proceeding. The Company has agreed to extend the time permitted under Rule 103 for Staff's sufficiency review and is willing to provide additional and updated information that is reasonably believed appropriate by Staff.

**2. Post-Test Year Plant Additions**

You also inquired about the propriety of APS's request to include in rate base plant placed into service after the end of the test year but prior to any Commission decision in this matter. There is no Commission rule that would prevent either the Company from making such proposal or the Commission from adopting it. To the contrary, as recently as 2002, the Commission rejected the argument that the inclusion of post-test year plant in rate base was inconsistent with the Commission's historical test year approach, and noted that it did "not agree . . . that the Commission has always required extraordinary circumstances to allow post-test year plant." Decision No. 65350.

The Commission further stated that it did "not believe that it is fair to *refuse* to consider post-test year plant when the majority of evidence indicates that there will not be a material mismatch between revenues and expenses and the investment in the plant." *Id.* (Emphasis supplied.) Moreover, in the past two APS rate decisions, this Commission approved the inclusion in rate base of post-test year plant additions. And, while discussing a slightly different regulatory tool, the Arizona Supreme Court has further ruled that "Construction Work in Progress (CWIP) not yet in service at the time rates are established may be included in determining a fair value rate base." *See Arizona Community Action Alliance v. Arizona Corporation Commission*, 123 Ariz. 228, 230, 599 P.2d 184, 186 (1979).

### 3. *Arizona Corporation Commission v. Arizona Public Service Company*

Finally, APS would offer these comments relative to *Arizona Corporation Commission v. Arizona Public Service Company*. That decision established two things: first, that the historic test-year rate making methodology traditionally used by the Commission is not *per se* unconstitutional, *provided that it does not result in rates that are confiscatory at the time they are set*, *id.* at 370-71, 555 P.2d 328-29; and, second, that it is well within the Commission's authority and discretion to consider factors subsequent to the cutoff of the historic test year, specifically including post-test year plant in service. *Id.* at 370, 555 P.2d at 328. ("A plant under construction is at least a relevant factor which the Commission could consider in determining fair value.")

In *Arizona Corporation Commission*, APS had argued that the use of a historic test year in inflationary times with rapidly expanding plant becomes confiscatory. Significantly, the Court found that, in that proceeding, there was "no evidentiary basis for holding that the rate set by the Commission is *at this juncture* confiscatory," and indicated that "[p]rospectively the rate may well become confiscatory, but [the Commission] contends that [APS's] relief lies in a new demand for rate adjustment."[3] *Id.* at 370, 555 P.2d at 328. In so holding, however, the Court indicated neither that the historic test-year rate-making practice will always produce rates that are just and reasonable nor that a future test year is impermissible. Rather, the Court reiterated that the Commission has a constitutional duty to ascertain the fair value of a utility's properties "at the time of the inquiry," which may include consideration of matters subsequent to the historic test year, so that the Company can earn a reasonable rate of return upon that value "at the time the rate is fixed." *Id.* at 370, 555 P.2d at 328.

* * * *

If you or members of your Staff have any further questions or wish us to provide additional legal authority on these matters, please feel free to contact me at any time.

Sincerely,

Thomas L. Mumaw

Thomas L. Mumaw
Attorney for Arizona Public Service Company

[3] This also supports the contention, discussed above, that there is not a legal requirement that a test year contain 12 months of data under existing rates.

TLM/
Enclosures
Cc:
Mike Gleason, Chairman
William A. Mundell, Commissioner
Jeff Hatch-Miller, Commissioner
Gary Pierce, Commissioner
Brian McNeil
Ernest Johnson
Janice Alward
Lyn Farmer
Rebecca Wilder
Docket Control

## HISTORY OF RATE INCREASE PROCEEDINGS SINCE ENACTMENT OF A.A.C. R14-2-103
## ARIZONA PUBLIC SERVICE

| Application Date | Test Year | Decision No. | Decision Date | Number of Months in Test Period Under Previously Authorized Rates |
|---|---|---|---|---|
| 5/1/81 | 12/31/80 | Phase I – 52558<br>Phase II – 53615 | Phase I – 11/1/81<br>Phase II – 6/27/83[1] | 7 |
| 8/27/82 | 6/30/82 | Phase I – 53761<br>Phase II – Cancelled | Phase I – 9/30/83<br>Phase II - Cancelled | 7[2] |
| 7/5/83 | 6/30/83 | Phase I – 54204<br>Phase II - 54247 | Phase I – 10/11/84<br>Phase II – 11/28/84 | 0[3] |
| | | | | |
| 5/24/85 | 12/31/84 | Phase I – 55118<br>Phase II – 55228 | Phase I – 7/24/86<br>Phase II – 10/9/86 | 1[4] |
| 12/18/85 | 5/31/85; updated to 12/31/85; updated to 9/30/86 | 55931 | 4/1/88 | 2[5] |
| 6/30/89 | 12/31/88 | 57649 | 12/6/91 | 8[6] |
| 6/27/03 | 12/31/02 | 67744 | 4/7/05 | 0[7] |
| 11/4/05; 1/31/06 | 9/30/05 | 69663 | 6/28/07 | 6[8] |

[1] Rate cases during the early 1980's were divided into phases, with the first establishing a revenue requirement and implementing new rates on an interim "across the board" basis. Phase II dealt with rate design and established the final rates.

[2] There were seven months of the Phase I rates in the test year ("TY"). There were no months of the Phase II (final) rates in the selected TY.

[3] The original TY for the filing was calendar 1982. The TY was later ordered updated to the indicated 12 months ending June 30, 1983 due to the length of the proceeding, but the test period required by the Commission still had no months under the rates approved 9/30/83.

[4] This was also after a subsequent update of the TY. The rate case was originally accepted by ACC with 0 months of current rates in the TY.

[5] This again was after a subsequent update of the TY. The rate case was originally accepted by the ACC with 0 months of current rates in the TY>

[6] TY was later updated as part of Settlement because of length of proceeding, but the rate case was accepted by the ACC using the earlier TY.

[7] The rates agreed to in 1999 Settlement did not go into effect until July 1, 2003 – some six months after close of the TY.

[8] This was after update of test period to the TY requested by ACC Staff.